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C O N F I D E N T I A L SECTION 01 OF 04 TOKYO 000408

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DEPT FOR EAP
ALSO FOR EEB/IFD: DIBBLE, BYERLY, AND KAMBARA
NSC FOR TONG
DEPT PASS USTR FOR CUTLER AND BEEMAN
USDOC FOR 4410/ITA/MAC/OJ/NMELCHER
JUSTICE FOR ANTITRUST DIVISION - CHEMTOB
TREASURY DEPT FOR IA/CARNES AND POGGI
GENEVA FOR USTR

E.O. 12958: DECL: 02/12/2012
TAGS: EINV ECON PREL PGOV OECD JA
SUBJECT: FOREIGN INVESTMENT IN JAPAN -- OBSTACLES REMAIN
DESPITE GOVERNMENT POLICIES

REF: A. TOKYO 317
¶B. TOKYO 324
¶C. 07 TOKYO 3689
¶D. 07 TOKYO 454

Classified By: Ambassador J. Thomas Schieffer. Reason 1.4 (b)(d)

¶1. (C) Summary: The GOJ maintains its policy of boosting foreign direct investment and the sharp rise in FDI inflows in 2007 show foreign investors are not "fleeing Japan". Recent high-profile debates over particular investment cases, public warnings by a cabinet member that Japan's investment climate has lost its attractiveness, and a METI Vice Minister's off-the-reservation remarks, however, show that problems persist and need to be addressed. Pessimism among many investors over the continued slow pace of reform in Japan and sharply eroding market sentiment have added further negative factors to a mix that includes on-going cultural and regulatory obstacles to investment, many of which the GOJ identified in a December 2007 FSA report. Whether the Fukuda government has the political will to follow through on its explicit investment agenda as it looks to consolidate the ruling party's support base in advance of elections later this year is an open question. End Summary.

No Change of Policy, Just Lack of Leadership

¶2. (SBU) A series of unconnected policy initiatives and statements by Japanese officials since the New Year raised doubts about the GOJ's commitment to promoting inward FDI. Most prominent among these events have been a Ministry of Land, Infrastructure, Transportation and Tourism (MLIT) draft bill that would limit foreign ownership in privatized

Japanese airport operators to 33 percent (septel), METI statements that it opposed a UK-based investment fund's (TCI) application to raise its stake in electricity wholesaler Electric Power Development Co. (known as "J-Power"), and public comments by METI Vice Minister Takao Kitabata denigrating shareholders's role in corporate governance (Ref A).

¶3. (U) All this negative news coincided with a sharp drop in the Tokyo Stock Exchange, exacerbating already bearish market sentiment. It also drowned out more positive news on the investment front including from PM Fukuda, whose January 18 Diet policy speech reiterated the government's goal of doubling the country's FDI stock by 2010. The METI Director of Industrial Organizations emphasized to Econoff Feb. 12 there is no change to government policy in promoting inward FDI and pointed to a recent sharp rise in inward M&A, from 171 cases worth 630 billion yen in 2006 to 308 cases worth 3 trillion yen in 2007. At the same time, Japan's FDI stock as of September 2007 (the latest figures available) was 15.4 trillion yen, up 20 percent over the year-end 2006 level, according to official Ministry of Finance figures.

¶4. (C) Also on the positive side, Cabinet proponents of economic reform, led by Financial Services Minister Watanabe and Minister for Economic and Fiscal Policy Ota -- with the help of some senior LDP Diet members -- have defeated, at least for the moment, MLIT's proposal to cap foreign ownership in Japan's airport operators. Meanwhile, METI announced it will extend its examination of TCI's application to increase its holdings in J-Power until mid-May while actively attempting to clarify Kitabata's remarks, in

response to strong press criticism and Embassy expressions of concern. Kitabata apologized Feb. 7 for his "inappropriate" comments and even METI Minister Akira Amari felt obliged to tell reporters the next day that his deputy's comments were "perhaps too radical" and "misleading."

Continuation of Long Existing Trends

¶5. (C) There was little new in any of these developments although their cumulative impact was magnified by eroding global investor sentiment. Kitabata's remarks, as shocking as they were, echoed his previous criticisms. He has made no secret of his antagonism to activist shareholders such as

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U.S.-based fund Steel Partners. In July 2007, he told reporters, "companies should be run for the benefit of stakeholders, not shareholders," and in November he criticized Steel Partners as an example of shareholders that "lack the experience needed to manage companies or enhance corporate values."

¶6. (C) The TCI/J-Power case triggers a 1991 law requiring foreign investors seeking to acquire over 10 percent of any company operating in a sensitive sector, including electricity generation and distribution, to obtain government approval in advance (Ref D). Significantly the government has never rejected a proposed investment under the 1991 law. Nor are there overall limits on the aggregate amount of foreign investment allowed in J-Power only on the size of individual stakes. (According to a recent company report, as of January 2008, 39.9 percent of J-Power's shares are held by foreigners. Approval of TCI's application would raise the level of foreign ownership to 49.9 percent.) In the same way, the MLIT proposal on airport operators mirrors a provision in the 1986 Law that privatized former state-owned telephone company NTT.

¶7. (C) More worrisome, though, is the case of Sapporo Holdings where the firm's nominally independent advisory committee concluded that a takeover bid by Steel Partners was

not in the best interests of the company or its shareholders (Ref B). Steel Partners consciously adopted a more conciliatory approach to Sapporo's board after the courts labeled it an "abusive acquirer" following Steel's failed 2007 effort to acquire the condiment maker Bull-Dog Sauce Co. Despite Kitabata's occasional sniping of the fund, the GOJ has taken no formal role in this case.

Some Reasons for Optimism

¶8. (C) In addition to the temporary derailment of MLIT's airport proposal, there have been other positive, if less reported, developments. Minister for Economic and Fiscal Policy Ota raised her public pro-reform profile by moving quickly to establish a new Experts Advisory Group on Investment to replace the disbanded ministerial-level Japan Investment Council, a body PM Koizumi had used to generate policy recommendations and FDI targets. Professor Haruo Shimada, chairman of the new group, told EMIN Ota wants to "awaken the public to the need for continued reform" and has instructed the working group to develop recommendations to improve Japan's new M&A rules (including the associated tax regulations for triangular mergers) and to examine other areas of investment-related regulatory reform. The committee expects to complete its draft report by mid-April to

influence the GOJ annual broad-based economic policy White Paper due out in June.

Foreign Investors Sell but Domestic Investors Won't Buy
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¶9. (SBU) Ota's renewed interest in reform was triggered, in part, by the sharp fall in Japan's equity markets since the first of the year. As of Feb. 12, the blue-chip Nikkei 225 is down over 15 percent from its level of December 28, the last trading day of 2007, and almost 27 percent below the seven-year high set in Feb. 2007. Although, foreign investors turned net sellers of Tokyo stocks in July 2007 for the first time since 2002 in response to the growing sub-prime problems in the U.S., the margin of net sales has been generally less than 1 percent of total trading volumes. The larger problem has been the lack of domestic buyers. Since July 2007, the percentage of trading on the TSE's First Section by foreign investors has risen from less than 50 percent to almost 70 percent. Foreign investor trading on the Osaka Stock Exchange has experienced a similar increase.

Japan Wants Investment but Prefers Certain Types
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¶10. (C) Despite the growing bearish sentiment towards Tokyo equities in recent months, investment bankers agree Japan's current legal framework for M&A is adequate. The major obstacles to increased foreign investment in Japan remain largely cultural and institutional, not legal and regulatory. Japanese business leaders continue to reject an increased role for activist shareholders in their company's activities and express mixed feelings toward the role of investment funds. Even a committed reformer like Tokyo Stock Exchange (TSE) President Atsushi Saito told Emboffs recently that Japan prefers "physical, real investment" in manufacturing or services over portfolio investment. Many businessmen consider the activities of investment funds to be "a money game" and not "real" investment, he concluded.

¶11. (C) The real worry of corporate Japan and senior economic bureaucrats like Vice Minister Kitabata is not too much foreign investment, but the loss of control of corporate assets. At the company level, the system discourages risk taking and rewards the status quo. As the head of Lazard Freres, Japan told Econoff recently, "Japan has too many salaryman CEOs." The professional and financial interests of a Japanese executive are linked to the continued

independent existence of his company. In most cases, such an executive has little or no equity stake in his firm and would receive no personal benefit from a boost in the company's share price or the premium price associated with a hostile takeover bid. Likewise, his retirement package is usually a lump sum payment and a relatively small pension program dependent on the good will and continued existence of the company. Finally, there is no explicit or implicit reward for risking the company's assets, regardless of the potential reward, unless the existence of the company is at stake. Such was the case in Citigroup's recent acquisition of the brokerage Nikko Cordial and the reason the deal was completed relatively quickly. Such risk aversion also makes a Japanese CEO more willing to prefer a deal, if no other options are possible, with a "white knight" buyer with which, in most cases, his company has a pre-existing relationship.

What Needs To Be Done

¶12. (C) There is wide agreement among both fund managers and investment bankers that the remaining obstacles to increased FDI in Japan are cultural and institutional, not legal. Several market participants with whom we spoke, including both fund managers and Japan Business Federation (Keidanren) officials, pointed to high corporate tax rates as a major burden. One U.S. fund manager told us cutting the top corporate rate of 41 percent is the single most important step the GOJ could take to encourage new investment flows. High rates, he said, discourage funds from setting up here and, if they are not here, potential deals are missed. He even added most foreign investors could live with elimination of the temporary 10 percent rate on capital gains and a return to the regular 20 percent rate in return for lower overall corporate rates.

¶13. (C) Second, policies should encourage a shift of more of the 1,500 trillion yen in personal financial assets held by Japanese households out of savings accounts and into the markets. This shift could be done by increasing the types of financial products offered on Japanese markets, adjusting tax rates to encourage savings over investment, and accelerating broad structural reforms that would stimulate domestic demand, increase the productivity of Japanese firms and trigger more economic growth.

¶14. (C) Finally, better corporate governance, especially an increase in the number and strengthening of the role of independent directors, would make it easier for investors to use M&A to unlock the hidden value in many Japanese listed firms. Lazard's CEO admitted to us that many of his clients see significant hidden value in Japanese companies which continue to have low return on equity and use capital inefficiently. However,given current attitudes of Japanese corporate directors, it is just too difficult to try to unlock that value.

¶15. (C) The FSA's December 2007 Report on Strengthening the Competitiveness of Japan's Financial and Capital Markets, addresses many of the policy reforms called for by market players, including increasing the variety of financial products offered on Tokyo's markets, strengthening self-regulation of markets, review of the firewalls between banks, brokerages and insurance providers, increased transparency of financial regulations and better corporate governance. If the GOJ implements many of the report's recommendations, it could have a dramatic, positive impact on Japan's investment climate. Unfortunately as the country moves closer to the next general election, the incentive to take on powerful corporate interests will wane. The major question is whether the government has the political will and the energy to follow through on its own explicit agenda.
SCHIEFFER